Letterhead of THE HONG KONG ASSOCIATION OF BANKS

30 June 2000

Ms Leung Siu-Kum
Clerk to Sub-Committee on Securities and Futures Bill
Legislative Council
Legislative Council Building
8 Jackson Road, Central
Hong Kong

Dear Ms Leung

Legislative Reform for the Securities and Futures Market
Consultation on the Securities and Futures Bill

Thank you for your letter of 8.4.00 inviting the Association's comments on the above Bill. Our comments are set out in the annexure.

In relation to the comments submitted by us, we would like to highlight a number of areas of key concerns for your kind attention:

(i) The interface between the HKMA and the SFC in terms of avoidance of over-regulation and dual processes (e.g. clauses 5(3), 118(4), 125 and 129(3))

(ii) Client asset and client money to be more clearly defined (e.g. clauses 141(4) and 142(1), (7) and (8))

(iii) Definition of "associated entity" and "controlling entity" to be refined (e.g. clause 137)

(iv) Appropriate segregation of other collaterals (e.g. clause 137)

(v) Exclusion of the clearing house operated by HKICL (e.g. clause 5(1)(b)(i))

(vi) Recognition of regulated activities not requiring exemption (e.g. clauses 5(d) and 162)

(vii) Implications on other banking business (i.e. custodian, nominee services etc), (e.g. clauses 145(1)(b), 145(5)(b) and 157(3))

We would much appreciate it if due consideration could be given to revising the clauses related to the above areas and the rationale supporting our request is set out in detail as part of our comments to the clauses in question.

In addition to the above key areas, a large part of the regulatory provisions in the Bill are drafted in terms of the ability of the Securities and Futures Commission to make rules dealing with particular matters. In order to understand the law fully, it will be necessary to read both the Bill and the rules, which have yet to be published. We have therefore urged the FSB to request the SFC to publish the draft rules as soon as possible and to extend the consultation period so that market participants could review the draft bill with the draft rules at the same time to provide detailed comments.

Yours sincerely

David May
Secretary

Enc.

c.c. Chairman, Securities and Futures Commission
Chief Executive, Hong Kong Monetary Authority

COMMENTS ON SECURITIES AND FUTURES BILL

(1) Clause 4 - Firstly, this clause as an aid of interpretation should not extend the functions and powers of the Securities and Futures Commission (SFC) and this should be made clear. Secondly, construing Clause 4 literally there is an inconsistency between the references to "securities and futures industry" and "financial products" which are expressed to fall within the regulatory objects of the SFC and the fact that authorised institutions do not require licensing in respect of certain activities (e.g. leveraged foreign exchange trading and securities margin financing) and in respect of other activities can obtain an exemption from licensing. Thirdly, we suggest that Clause 4(f) be deleted as the SFC should not become a fiscal policy implementer, as this would bias its primary role as a provider of market framework.

(2) Clause 5(1) - This clause also uses the words "securities and futures industry" and "financial products". It does therefore seem to express the functions of the SFC in a way which includes areas which for authorised institutions are not regulated or for which they are entitled to obtain an exemption. This interpretation is substantiated by paragraphs (b) and (m) where specific reference is made to "exempt persons". The natural consequence of this is that where exempt persons are not referred to in general language, that general language would apply to them. We would suggest that this issue be dealt with by adding words along the lines of "in accordance with the terms of this Ordinance" after "so far as reasonably practicable" in the introductory language.

(3) Clause 5(1)(b)(i) - This includes as a function a requirement to supervise and monitor *inter alia* recognised clearing houses. Under Clause 18(1), a "recognised clearing house" means a clearing house recognised as a clearing house under Clause 38(1). For the avoidance of doubt, Clause 5 or Clause 38 should be clarified to exclude the clearing house operated by Hong Kong Interbank Clearing Limited. Arrangements for the settlement of payments should not be affected by the Bill.

(4) Clauses 5(1)(b)(ii) and (m)(ii) - These provisions relate to the regulation of exempt persons "under any of the relevant provisions". The "relevant provisions" are defined to include all provisions of the Bill together with certain provision in the

Companies Ordinance. The literal reading of this is that all provisions of the Bill will apply to exempt persons whereas in fact only some of the provisions of the Bill should apply to exempt persons. We would therefore suggest that the words "which are expressed to apply to them" be inserted after the words "relevant provisions".

(5) Clause 5(d) - The words "persons carrying on activities regulated by the Commission under any of the relevant provisions" are too wide in that they do not reflect the fact that authorised institutions are not required to be licensed in respect of some regulated activities and can claim exemption from others. We suggest the words "which apply to them" be inserted after "relevant provisions".

(6) Clause 5(3) - This states that in relation to the performance by the SFC of any of its functions, it may rely in whole or in part on the supervision of authorised institutions by the Monetary Authority (MA). As we understand it, the intention is that a large part of the regulation of exempt persons will be performed by the MA under amendments to be made to the Banking Ordinance. It seems to us that to the extent that the MA performs these regulatory functions, the SFC should have no role. In the light of this, we suggest that the wording of this provision should refer to the regulation of authorised institutions under the Banking Ordinance and should require the SFC to rely on the supervision of authorised institutions by the MA. In other words, the provision should be mandatory rather than permissive.

(7) Clauses 5(4)(e) and (f) - These provisions which relate to publication of materials should not extend the powers of the SFC but rather should explain how the SFC will exercise discretions.

(8) Clause 112(2)(b) - This states that an individual should be regarded as carrying on a regulated activity if he performs or takes part in any act which constitutes that regulated activity; this wording is repeated elsewhere in the Bill. The words "takes part in" are potentially too wide and could catch an individual who is not carrying on any regulated activity but deals for example on the other side with a person who is carrying on a regulated activity. We suggest that the words "performs any act which constitutes that regulated activity" are sufficient. At least what constitutes "taking part" for this purpose should be clarified and

defined, and be restricted, for example, to those dealing directly with a client.

(9) Clause 113(1) - The carve out from this clause, as currently drafted, is limited to corporations which have been licensed exempt persons and persons who have been authorised to provide automated trading services. For the purpose of completeness, it should also allow the carrying on of regulated activities by licensed representatives and responsible officers of licensed corporations as well as executive officers of exempt persons.

(10) Clause 114(1) - This clause also includes the words "perform or take part in" and should be clarified, defined and restricted (see point (8) above).

(11) Clauses 114(2) and (3) - These provisions contain exemptions for providing advice on securities, futures contracts or corporate finance if it is on an irregular basis and for no remuneration and for managing a portfolio for no remuneration. These carve outs should also be included in Clause 113 to make it clear that a person who offers advice on an irregular basis and for no remuneration or manages a portfolio for no remuneration should not be regarded as carrying on a business within the meaning of Clause 113.

(12) Clause 115(6) - This requires conditions attached to the granting of a licence to be reasonable. It also enables the SFC to amend conditions or impose new conditions. This should state that the amended or new conditions should also be reasonable.

(13) Clause 118(4) - This provides that the SFC will refuse to grant an exemption unless the MA is satisfied that the applicant is a fit and proper person and the SFC is also satisfied that it is a fit and proper person. Applicants will therefore need to satisfy both regulators. We query whether it should be sufficient in relation to authorised financial institutions that they satisfy the MA that they are fit and proper persons.

(14) Clause 118(5) - This entitles the SFC to impose reasonable conditions on any exemption and to amend or revoke any such conditions. We query whether the person should be the MA who has considered the application. Also, any amended or new

conditions should meet the test of reasonableness (see point (12) above).

(15) Clause 119 - It would be useful to receive clear and unambiguous guidelines from the SFC or the MA on exactly the types of activities carried on by any staff within an authorised institution/exempt person which would require accreditation of such staff to a regulated activity. For instance, the guidelines could provide that only staff dealing directly with clients by giving investment advice or soliciting orders in respect of securities transactions would require accreditation. Similar to point (8) above, the words "take part" in Clause 119(1) should be restricted or deleted.

(16) Clause 123(3) - A breach of this section (being at least one responsible person in Hong Kong at all times) is quite draconian. There could be very justifiable (and unforseeable) circumstances which led to such breach, e.g., dismissal, death of one and the other responsible person happened to be overseas at that time. This liability should not be strict liability in all circumstances.

(17) Clause 125 - This requires that authorised financial institutions applying for exemption or variation or modifications of exemptions should provide the SFC with such information as may be prescribed. It seems appropriate that this information should be provided to the MA which is the body which should be responsible for considering applications for exemptions, variations and modifications.

(18) Clauses 125(2) and (3) - Again, this should refer to information in the possession of the MA and for the making of rules relating to information to be provided by applicants for the MA to consider applications.

(19) Clause 126(1) - This makes provisions for the factors which the SFC should consider in relation to a determination whether a person is a fit and proper person. This should also apply to the MA in relation to determinations related to authorised financial institutions. A similar issue applies in relation to Clause 126(2).

(20) Clause 129 - It seems to us that in relation to exempt authorised financial institutions, the application should be made to the MA and the decision should be by the MA (see Clause 118) even

though the result of the application is the granting of a modification or waiver by the SFC.

(21) Clause 129(3) - This empowers the SFC to grant modifications or waivers to a class of exempt authorised financial institutions. The decision making process in relation to this should be conducted by the MA even though the granting of the modification and waiver is by the SFC. A similar consideration applies to Clause 129(4) which relates to the imposition of conditions to modifications or waivers. Also, the power to amend or revoke conditions to modifications or waivers should be exercised such that the resulting conditions are reasonable (see point (12) above).

(22) Clause 129(5)(b) - The decision making process in relation to revocation or modifications or waivers granted to authorised financial institutions should be by the MA.

(23) Clauses 129(6) and (7) - Again, these Clauses should refer to the decision making process of the MA in relation to exempt authorised financial institutions even though the relevant modification or waiver is eventually granted by the SFC.

(24) Clauses 130(1) and (2) - This makes provision for an exempt authorised financial institution to give notice of any cessation of business or change of address to the SFC. We suggest that the information should be submitted by exempt authorised financial institutions to the MA, who will arrange to forward the same to the SFC.

(25) Clause 130(3)(b) - This requires that when any information has been provided to the SFC in connection with an application (including an application for exemption) which has been granted or in connection with any other matter, the person must within seven days of any change in the information give the SFC notice in writing of the change containing a full description of it. First, the words "in connection ... with any other matter" are too wide and should be deleted. Secondly, it may not be practicable for information provided to the SFC in connection with an application to be constantly updated. This may relate to information which has been provided many years ago and which it is difficult to monitor. Should not the provision be limited to certain particular types of information which it is easy to keep

updated? Thirdly, we suggest that the information should be submitted by exempt authorised financial institutions to the MA, who will arrange to forward the same to the SFC.

(26) Clause 130(4) - This requires an exempt authorised financial institution to notify the SFC in writing of the names and addresses of any person who becomes or ceases to be a director. Authorised financial institutions incorporated in Hong Kong are already required to obtain the consent of the MA for the appointment of directors and it seems to us that the requirement to report changes in directors (so as to include changes in directors of authorised financial institutions incorporated outside Hong Kong) should more properly be incorporated in the Banking Ordinance (see Section 71 of the Banking Ordinance).

(27) Clause 130(5) - This clause is similar to the previous bill which required compliance officers to blow the whistle on the licensed corporation or exempt person. For the same reasons then, this clause is too onerous for any executive officers and leaves them under threat of dismissal if they complied with it, or under criminal liability if they failed to comply with it.

(28) Clauses 131 and 132 - These clauses provide for the SFC to maintain a register of exempt authorised financial institutions, the nature of their exemption, place of business and executive officer and to publish in the gazette certain information related to exempt authorised financial institutions. This is to an extent duplicative of Sections 20 and 21 of the Banking Ordinance and we feel that exempt authorised financial institutions should be excluded from these provisions.

(29) Clause 133 - It is not stated what the annual return is to contain but given the very detailed information which is required to be provided by exempt authorised financial institutions to the MA under the Banking Ordinance, we question whether it is appropriate that a further return should be made to the SFC under this clause. Also, a distinction should be made between exempt authorised financial institutions and licensed corporations as regards the amount of the annual fee payable to reflect the lower level of regulation for exempt authorised financial institutions.

(30) Clause 135 - This provision should also cover the imposition, variation or modification of conditions and should also require

the SFC to give reasons for the proposal to refuse the application, to impose conditions or to vary or modify conditions prior to the hearing of the applicant. This will enable the applicant to address these reasons in the hearing.

(31) Clause 137 - Definitions of "associated entity" and "controlling entity". The combination of these definitions is that an associated entity is one in which the licensed corporation or exempt authorised financial institution or a minority shareholder of the licensed corporation or exempt authorised financial institution has a very limited interest. We query whether the definition of "controlling entity" should be changed to reflect control of the associated entity by the licensed corporation or the exempt authorised financial institution or by the controlling shareholder of the licensed corporation or the exempt authorised financial institution.

(32) Clause 137 - Definitions of "other collateral" and "securities collateral". These definitions could apply to any form of collateral security obtained by an exempt authorised financial institution from a customer which are unrelated to the businesses for which it has obtained exemption. Further, "Corporation" is defined in the general definition Schedule 1 as a company incorporated either in Hong Kong or elsewhere unless such company is exempted by the rules of the SFC. We suggest that the definitions of "associated entity" and "controlling entity" should be limited to Hong Kong associated entities, otherwise it would create unnecessary regulatory and administrative burden to such companies.

(33) Clauses 141(1), 141(7)(a) and (8)(a) - We query whether it is appropriate that clause 141(1) should extend to exempt authorised financial institutions. Clauses 141(7)(a) and (8)(a) state that the clause and the rules made under the clause will only apply to securities *received* or held by exempt authorised financial institutions in the course of the regulated activities for which they are exempt. However it follows that once securities are received in the course of regulated activities, the securities are and always remain subject to the application of the clause and the rules. The clause does not distinguish between "trading" and "custodian" securities, and would catch all "custodian" securities which were "originated" in the course of regulated activities. The clause would require different custodian accounts for the

purposes of receiving and holding different securities depending on their "source". Such a distinction cannot be drawn in practice beyond the books of the exempt person, or at the level of accounts with third party custodians particularly accounts with clearing houses where the securities are held by common depositaries. Even at the level of the exempt person, different treatment depending on the origin of the securities would mean that different sets of documents and different accounts would be required, compelling authorised financial institutions to draw a sharp line between their banking, custodian and securities businesses. Furthermore, bank security documents generally create a security interest over all of a client's assets including all securities held by the bank, with the level of securities caught being dependent on the level of the client's indebtedness to the bank from time to time, without distinguishing between the sources of the client's securities. It would not be practicable to segregate securities which relate to or are "originated" from the business of the exempt authorised financial institution for which it has an exemption from other securities held by it on behalf of customers.

(34) Clause 141(2)(g) - This paragraph in effect or potentially empowers the SFC to regulate the business of securities custody. It is too wide, details are needed and to leave such regulation to the rules does not appear desirable. Presumably any rules would only limit intermediaries' ability to deal with unauthorised custodian institutions. However, it would in practice be difficult to distinguish between custodians chosen (or approved) by (a) a client and (b) the intermediary. If clients' freedom of choice is not to be affected (which should be the case as custodian business is not regulated), the regulation would be difficult to apply.

(35) Clause 141(2)(i) - This is one of the paragraphs describing the rules which may be made by the SFC regarding client securities. It is drafted too wide. It needs to be redrafted to specify more clearly what should be covered. The Bill itself is quite long. Many of its provisions however only provide for regulation to be effected by means of rules. These rules may also be long as they contain the substance of the regulation. It will be necessary to refer to both documents in order to understand the law. The situation that substantive regulations are contained in rules gives much increased scope for the question whether any particular rule is ultra vires the Ordinance to be raised and argued. Whether

these are desirable, and whether flexibility cannot be achieved without ridding the Ordinance of substantive regulations, may be debated.

(36) Clauses 141(2)(b) and (c) and 141(3)(a) - Where securities are held as collateral for a liability of the client (or a third party if the client agrees), disposal should be permitted in the event of default by the client (or the third party), if the client has agreed to such disposal when the client created the collateral. It is preferable to permit clearly such disposal in the Ordinance, rather than for it to be left to the rules. Similarly and for the avoidance of doubt, it should be clarified either in this Clause or in Clause 142 that any sales proceeds from such disposal may then be used to reduce the liability of the client to the intermediary or associated entity, since client assets include client money.

Clauses 141(2)(b) and (e) and 141(3)(a) appear to overlap to some extent. Different terms are used to describe the actions to be regulated, i.e., "deposited, transferred ...", "dealt with" and "disposal", but some of these terms cover the same actions. While the words "a lawful claim or lien" in Clause 141(2)(e) refer to a claim or lien of the intermediary as well as a third party, it is presumably not the intention to permit any dealing by the intermediary which affects a third party's claim or lien. If the claim or lien refers only to that of the intermediary, it may be made clear. The words "a debt or ... a liability *of* the intermediary" in Clause 141(3)(a) suggest that the paragraph relates to a disposal in reduction of a debt or liability which is owed by the intermediary to a third party, rather than a debt or liability owed by the client to the intermediary. The position may be made clearer.

Further, it is not uncommon that the client has agreed in the contract that the authorised institution has the power to dispose of any property (including securities) of the client which is in the possession or control of the authorised institution to satisfy any obligations, indebtedness and liabilities owed by the client to the authorised institution. It is preferable to permit clearly such disposal in the Ordinance rather than for it to be left to the rules.

(37) Clause 141(4) - This provides that any disposal of securities in contravention of Clause 141(3) is void and a person who acquires them does not obtain any title to them. As securities are

essentially fungible and the third party has in practice no way of knowing whether the securities are client assets, there should be an exemption from this provision in relation to persons who obtain securities for value in good faith and without notice of breach of Clause 141(3). It would otherwise be entirely unsafe for any person to acquire any securities from intermediaries. Clause 143 needs to be amended accordingly.

(38) Clauses 141(7)(b) and (8)(b) - First, we question whether it is appropriate that the clause should apply to an associated entity of a licensed corporation or authorised financial institution which itself is an authorised financial institution. Secondly, the provisions state that the clause and the rules made under the clause will only apply to the receiving or holding of client securities of licensed corporations or exempt authorised financial institutions of which they are associated entities. Again, we query whether it will be possible to make this distinction in practice. The words "client assets of intermediaries" suggest that assets, not of the intermediary, but of the clients of the intermediary are to be caught. If client assets transferred by an intermediary to an associated entity to hold is designated as such by the intermediary, the associated entity will know that they are client assets subject to regulation. If the intermediary fails to disclose that they are client assets, is the associated entity supposed to know? If it does not know, is it nevertheless to be responsible? The "connection" between the intermediary and an associated entity which the definition of "associated entity" provides for is not sufficiently close to impute the intermediary's knowledge to the associated entity.

(39) Clauses 142(1), (7) and (8) - We query whether it is appropriate that this clause which deals with client money held by licensed corporations should also apply to associated entities of licensed corporations which themselves are authorised financial institutions. The clause is drafted so that it does apply to such authorised financial institutions but then Clauses 141(7) and (8) state that the clause and rules made under it would only apply to client money held by them in the course of the business of holding client money of licensed corporations of which they are associated entities. The problem discussed in point (38) above also arises here. While client money is required to be paid into segregated trust or client accounts (Clause 142(2)(a)), the wording catches all client money even if any such money is for

whatever reason not paid into a trust or client account. How is an authorised financial institution to know whether any money is or is not client money of a licensed corporation? The handling of money and "client money" by authorised financial institutions should be entirely excluded from the requirements under the Bill, as pointed out in paragraph 5.55(b) of the Consultation Document on the Bill. It should be made clear in this clause that an authorised institution's general right of set-off will not be affected by any restriction in this clause.

(40) Clause 142(2)(m) - This is a rule making power which is far too broad and vague (see point (35) above).

(41) Clause 142(3) - We are not sure how this clause which restricts payment of client money can apply to an associated entity of a licensed corporation where the associated entity is itself an authorised financial institution. Money being fungible it will be impossible to tell whether any money paid out by an authorised financial institution is client money.

(42) Clause 142(4) - This provides for a disposal of client money in contravention of Clause 142(3) being void. There should be an exception for a person dealing for value in good faith and without notice of the breach of the clause and Clause 143 needs to be amended accordingly. See also point 37 above.

(43) Clauses 144(1)(a) and (10)(a) - Clause 144 makes provision for rules to deal with the keeping of records by licensed corporations and exempt authorised financial institutions. We query whether these provisions should apply to exempt authorised financial institutions. It will be impracticable to distinguish in practice between accounts and records of the exempt authorised financial institution in relation to which it has an exemption and other accounts and records held by the exempt authorised financial institution.

(44) Clauses 144(1)(b) and (10)(b) - We doubt whether these provisions should apply to associated entities which are themselves authorised financial institutions. It would be difficult to identify in practice which accounts and records and client assets are covered by this clause.

(45) Clause 144(2)(f) - This contains a rule making provision which is too broad and vague (see point (35) above).

(46) Clauses 145(1)(a) and (5)(a) - We question whether these provisions should apply to exempt authorised financial institutions. It will be difficult in practice to determine (particularly in relation to receipts and statements of account) whether they relate to the regulated activities for which the exemption is held.

(47) Clauses 145(1)(b) and (5)(b) - Again, we query whether these provisions should apply to authorised financial institutions. It will be difficult to make a distinction between receipts, statements of account and notifications relating to their business of receiving or holding client assets of licensed corporations or exempt authorised financial institutions for which they are associated entities or other assets of licensed corporations or exempt authorised financial institutions.

(48) Clause 145(2)(g) - This is a rule making provision which is far too broad and general (see point (35) above).

(49) Part VI, Division 5 Generally - In view of the audit provisions in the Banking Ordinance that apply to authorised financial institutions, Division 5 of the Bill should not apply to associated entities of licensed corporations which themselves are authorised financial institutions. If it is intended that the audit provisions in the Bill should apply to authorised financial institutions which are associated entities of licensed corporations, then we think that this would be better addressed by amendments made to the Banking Ordinance so that authorised financial institutions are not subject to separate provisions regarding audit under the Banking Ordinance and under the Bill. This should be a matter for liaison between the SFC and the MA such that if in relation to any authorised financial institution which is an associated entity of a licensed corporation, the SFC has any concern that should be reported to the MA who should then consider exercising powers under the Banking Ordinance in relation to audit.

(50) Clause 156(3) - This contains a partial reversal of the burden of proof which may be contrary to the Hong Kong Bill of Rights Ordinance in that once it is proved a person has deleted,

destroyed, mutilated, falsified, concealed or altered any document, it is then for that person to prove that he did not do so with intent to prevent, delay or obstruct the carrying out of any examination or audit. We note, however, that a similar provision is already included in the Securities Ordinance.

(51) Clauses 157(1) and (8) - We query whether this should apply to an associated entity which itself is an authorised financial institution. It will be difficult in practice to distinguish between client assets and other assets of licensed corporations or exempt authorised financial institutions.

(52) Clause 157(3) - This sub-clause restricts an associated entity of an intermediary (other than an authorised financial institution) to provide nominee service for the intermediary, its clients or its associated entities only but not for any other business or other types of clients unless with the SFC's approval. As it is not uncommon at present for a non-authorised financial institution in a banking group to conduct other business in addition to being an associated entity of an intermediary and for a wide variety of clients, the restriction is too restrictive and would create unnecessary regulatory and administrative burden to such companies.

(53) Clause 159(1) - We query whether this should apply to exempt authorised financial institutions. In the event that it is decided that it is to apply to exempt authorised financial institution, it should make it clear that it should not apply to authorised financial institutions in relation to regulated activities for which they neither require a licence nor an exemption (i.e. leveraged foreign exchange trading or securities margin financing). The same should also be clarified in Clause 159(2) particularly in relation to client contracts which are defined widely in Clause 159(5) and financial products which are defined to include leveraged foreign exchange contracts.

(54) Clause 159(2)(n) - This rule making provision is far too broad and vague (see point (35) above).

(55) Clause 160(1) - We query whether this should apply to exempt authorised financial institutions. In the event it does, it should exclude regulated activities in relation to which exempt

authorised financial institutions do not need to be licensed or exempted.

(56) Clauses 160(2) and (4) - Clause 160(2) refers to provisions in codes of conduct containing "obligations" whereas Clause 160(4) states that failure to comply with provisions set out in a code of conduct will not give rise to any judicial or other proceedings. In view of this, the use of the word "obligations" in Clause 160(2) is misleading and should refer to guidelines or some other wording which more accurately reflects the nature of the codes of conduct.

(57) Clause 161 - It is not clear why it is not possible to obtain an exemption in relation to options trading given the broad ability to obtain exemption in relation to other categories of regulated business. Further, the new Section 161 has extended the current ambit of Section 76 of the Securities Ordinance which restricts dealers from transacting in Hong Kong any options over securities listed on the Exchange. The new section provides that the SFC may make rules prohibiting dealers from transacting in Hong Kong any options over any securities. As no rules have been issued with regard to Section 161(1), we can only review this section in its existing context. We are concerned that Section 161(1) as drafted is extremely wide and may operate to restrict the development of the derivatives trading business in Hong Kong for the future. We therefore recommend that the rationale for the enactment of Section 76 be re-visited to see if the reasons for its enactment are applicable at present.

(58) Clause 162 - We query whether this should apply to exempt authorised financial institutions in respect of leveraged foreign exchange contracts and securities margin trading for which authorised financial institutions do not require a licence or an exemption.

(59) Clauses 229 and 273 - Parts XIII and XIV are very long and difficult to read. Efforts should be made to avoid repetition and to streamline them so that a common topic can be dealt in one division rather than split into different parts. For instance, certain definitions in these two clauses are duplicated. See also Clauses 253 and 279, 257 and 283, 258 and 284, 259 and 285, 260 and 286, 261 and 287, 265 and 291 which seem to duplicate the meaning of each of the categories of market misconduct; and

Clauses 254(7) and 280(7) which seem to duplicate one of the defences available to insider dealing and we query if sub-sections (a) and (b) of these two clauses should be disjunctive ("or") rather than conjunctive ("and"); and Clause 106 seems to duplicate some of the offences in these Parts. There should also be an express exemption from insider dealing for mortgagees of shares when disposing of those shares pursuant to the relevant collateral arrangement upon default by the mortgagor where the mortgagor is the corporation or a connected person and such default may be material but not as yet made public.

(60) Clause 257 - False trading. The new definition in this Clause expands the existing Section 135 to cover not only a person who acts intentionally or recklessly, but who does anything that is likely to create a false or misleading appearance with respect to trading or the market for listed securities. This is wide enough to find someone guilty of false trading even though he did not think (and therefore had no intention) that his action could create such a false appearance, and even if the market was not misled. We would suggest that the existing definition be kept, i.e., restricted to persons who had the intention to create a false or misleading market. The concept of "artificial pricing" is also wide and vague and more specific rules or safe harbours should be introduced in light of the stiff penalty involved. We also query the territorial scope of this offence as Clause 283(2) covers securities traded on an overseas stock market.

(61) Clauses 258 and 284 - Some of the categories of price rigging in these clauses overlap with the offence of false trading, such as transactions not involving beneficial ownership. Perhaps these two offences can be merged as one to reduce the categories of "market misconduct" and avoid repetition. Like false trading, this is a strict liability offence, where the burden of proof is shifted to the defendant (which in our view is too onerous). These comments are also applicable to Clauses 263 and 289 in respect of price rigging in futures.

(62) Clauses 264 and 290 - We query the need to make an offence of the disclosure of information about transactions that are in themselves an offence.

(63) Clauses 260 and 286 - The scope of stock market manipulation is very wide such that it catches any transaction that increases,

reduces or stabilizes the price of securities, even if there is no intention to manipulate the market, and thus may catch genuine hedging transactions. We suggest that this category of market misconduct is unnecessary since they could fall within false trading.

(64) Clauses 261, 265, 287 and 291 - We suggest that the disclosure of false or misleading information inducing transactions in securities be made an offence only if such disclosure was made intentionally for that purpose or recklessly. In addition to the criminal liability for such information, we note a new provision, Clause 200, which imposes a civil liability. Since there is a similar provision creating civil liability in Clause 107, perhaps these two provisions could be merged and the test for civil liability in Clause 107 be used instead.

(65) Clause 298 - Definition of "relevant share capital". The definition of Relevant Share Capital for the purposes of the disclosure of interests obligations includes unissued share capital such as warrants. There is currently no publicly available source of information on the issued and unissued share capital of listed companies which would enable shareholders to know that they have reached the disclosure threshold and report their interest within the requisite period of 3 days. Accordingly unless such information is made available, investors will not be able to discharge their legal duty within the prescribed time-frame.

(66) Clause 310 - The drafting of the clause states that it applies in relation to various kinds of agreement but the clause itself, apart from describing the nature of the agreement covered by it and providing certain exclusions and definitions, does not contain any substantive provision. There should be a sub-section which states that for the purpose of the Ordinance one party to the concert party agreement is interested in shares acquired by the other party pursuant to the agreement.

More importantly the clause makes provisions for a new category of concert party agreement which is described in Clause 310(1)(b). This covers the making of a loan or the providing of security for a loan by a controlling shareholder or a director of the target company. The parties to the loan agreement or the security agreement would then become concert parties for the purpose of disclosure or for the purpose of the provisions

regarding the duty to keep parties informed. We believe the intention is that the new provision will not apply to a loan made by an authorised financial institution in the ordinary course of business (see Clause 310 (6)). However, this exemption is not sufficiently widely drawn because it only applies to an agreement for the making up a loan. It would not apply to an agreement for the provision of security by a controlling person in favour of an authorised financial institution. Thus the security agreement between the controlling person and the authorised financial institution would be an agreement covered by Clause 310 and the authorised financial institution would be deemed to be a person having an interest in shares acquired if it knew the loan was to be used for the purpose of acquisition of an interest in shares in the share capital of the target company. We believe that this is not intention of the Bill and it seems to us that Clause 310(6) needs to be extended to cover an agreement for the provision of security to an authorised financial institution in respect of a loan made by it in the ordinary course of business.

(67) Clauses 367 and 368 and liability of senior management and corporation in general - In light of the many offences under market misconduct and the strict liability approach, we are very concerned with these clauses which expand the normal scope for vicarious liability and personal liability of individuals (which includes liability for even "neglect"). We would suggest that these and other clauses which impose severe criminal or civil liability on the licensed corporation and its senior management be reconsidered against and brought in line with (but not greater than) other jurisdictions. Clauses 367(3) and 107(3) also have a different test for liability from that in Clause 268(4). We suggest that the test in the latter be adopted, i.e., applicable only where the misconduct was committed with the knowledge, consent or connivance of that officer.

(68) Part XV - We note the threshold for disclosure of interests in securities has been reduced to 5% and disclosure period to 3 business days which is in line with other markets. However the definition of interests and the information to be disclosed are far more extensive than the other markets. For instance, under Schedule 9 Part 7, disclosure of the consideration paid to acquire interests over the preceding 4 months is administratively onerous; and the effect of Clause 304(1)(d) would require the disclosure of securities that are loaned by a lender under a stock borrowing

and lending agreement because of a change in the nature of his interest (notwithstanding that there is no change in his level of interest). This impacts affiliates of authorised institutions which provide custody services and may also engage in securities lending with the consent of and without prior notification to their clients, being the beneficial owners of the securities. This Part is also very complicated and we are concerned that non-compliance may inadvertently occur because of a failure to understand the rules accurately.

(69) Schedule 6, Part II - Definition of "advising on corporate finance", Paragraph (i) - This should refer to the giving of advice by a corporation to any of its subsidiaries, parent companies or subsidiaries of parent companies. It does not seem to be necessary that the subsidiaries should be wholly owned as long as they comply with the Companies Ordinance definition. Paragraph (c) extends to advice concerning the restructuring of any corporation or any of its assets and could therefore catch debt restructuring of a company and thus staff involved in asset restructuring and recovery in an authorised institution.

(70) Schedule 6, Part II - Definition of "advising on futures contracts", Paragraph (i) - Again, this should refer to advice given to subsidiaries, parent companies or subsidiaries of parent companies in accordance with the Companies Ordinance definition.

(71) Schedule 6, Part II - Definition of "advising on securities", Paragraph (i) - Again, this should refer to subsidiaries, parent companies and subsidiaries of parent companies in accordance with the Companies Ordinance definition.

(72) Schedule 6, Part II - Definition of "automated trading services" - As this definition is quite wide and unclear, further clarification is needed to ascertain whether companies that provide on-line services to investors to deal in Hong Kong or foreign listed securities would need to be licensed under this category. How would this apply to authorised institutions and companies already licensed as a securities dealer? Paragraph (c) of the definition refers to providing of electronic facilities by which transactions resulting from the sale of securities or futures are novated, cleared, settled or guaranteed. This would be wide enough to cover the activities of Hong Kong Interbank Clearing Ltd in

relation to the operation of the clearing house. Presumably, it is not intended that Hong Kong Interbank Clearing Ltd will be required to obtain a licence and this should be an exception.

(73) Schedule 6, Part II - Definition of "automated trading services" and "dealing in securities", paragraph (b) - There appears to be an overlap here which raises the question of whether a person licensed to deal in securities would also need to be licensed to provide automated trading services and vice-versa. We note that the existing professionals exemption in the definition of "dealing in securities" (in sub-paragraph (b)(v)) continues but would like to have express clarification that even high networth individuals (namely, private bank clients) or their investment holding companies or trusts would fall within this exemption.

(74) Definition of "leveraged foreign exchange trading" - To tie in with the wording in Schedule 6, Part I, Paragraph (c), this definition should be "trading in leveraged foreign exchange contracts".

(75) Schedule 9, Clause 22 - In relation to Clause 22 (a), this means that as soon as an event of default has occurred in respect of a loan transaction which entitles the lender to enforce its security any shares held by way of security will cease to be an exempt security interest. Events of default would normally cover a wide spectrum of circumstances which at one end would include a payment default and at the other end would include defaults in relation to less significant matters such as failure to deliver accounts within any applicable deadline. It seems wrong in principle that the mere existence of the occurrence of an event of default without more should give rise to interests in shares ceasing to be exempt security interests. There should be a default followed by some further action which is taken for foreclosure or sale of the shares concerned.

In relation to Clause 22 (b), this is far closer to what might be regarded as reasonable in that a power of sale must have arisen and the chargee must have offered the shares for sale. We suggest however that in relation to the enforcement of security the offer for sale should be in the form of a binding, specific offer to a specific purchaser rather than an offer in the sense of seeking to find persons who are interested in purchasing the shares. If this latter kind of offer is the trigger of the cessation of an exempt

security interest that cessation will occur a lot earlier than the time when the chargee is actually formally enforcing his security interest.

- End -